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## NOTES

### THE FAILING COMPANY DOCTRINE SINCE *GENERAL DYNAMICS*: MORE THAN EXCESS BAGGAGE

#### INTRODUCTION

Section 7 of the Clayton Act<sup>1</sup> is designed to prevent any merger<sup>2</sup> that would substantially lessen competition or create a monopoly within a particular industry.<sup>3</sup> Because a horizontal merger, in which two competitors combine to form a single entity, presents a threat to competition, the Justice Department<sup>4</sup> carefully examines the market share of the resulting company and the trend toward concentration in the industry in order to determine the merger's probable anticompetitive effects.<sup>5</sup> It has long been recognized, however, that a merger

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1. 15 U.S.C. § 18 (1976).

2. The types of mergers covered by § 7 include horizontal, vertical, and conglomerate mergers. A horizontal merger occurs when the merging companies are direct competitors in the same product line and geographic market. *See, e.g.,* United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963). A vertical merger occurs when a company merges with one of its suppliers or purchasers. *See, e.g.,* United States v. E. I. du Pont de Nemours & Co., 353 U.S. 586 (1957). Conglomerate mergers are neither vertical nor horizontal, but rather involve two merging companies that operated in totally unrelated markets prior to the merger. *See, e.g.,* United States v. International Tel. & Tel. Corp., 324 F. Supp. 19 (D. Conn. 1970), *appeal dismissed*, 404 U.S. 801 (1972). Another type of merger, related to both conglomerate and horizontal mergers, is the market extension merger that occurs in one of two ways. In a geographic extension merger, the merging companies market the same product in different areas of the country. *See, e.g.,* United States v. Marine Bancorporation, 418 U.S. 602 (1974). In a product extension merger, the merging companies operate within the same industry but are not in direct competition because their products are not identical. *See, e.g.,* FTC v. Procter & Gamble Co., 386 U.S. 568 (1967). *See generally* Merger Guidelines of Department of Justice (1968), *reprinted in* [1977] Trade Reg. Rep. (CCH) ¶ 4510 [hereinafter referred to as Merger Guidelines]; L. Sullivan, *Handbook of the Law of Antitrust* §§ 202, 205, 207 (1977). This Note will focus on horizontal merger cases because the failing company doctrine, while not limited in theory to horizontal mergers, has been applied primarily in such cases.

3. Section 7 provides in pertinent part: "No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." 15 U.S.C. § 18 (1976).

4. Both the Justice Department and the Federal Trade Commission may bring suits to enforce § 7. 15 U.S.C. §§ 21, 25 (1976). Suit may be brought either to enjoin a proposed merger or to order divestiture of a merger that has already occurred. *Id.* § 25. Private plaintiffs may also sue under § 7 for treble damages and equitable relief. *Id.* §§ 15, 26 (1976).

5. To determine whether the market share is acceptable or in violation of the law, the Justice Department first considers its absolute size, measured as a percentage of the market, and then considers whether this share of the market is too great in relation to concentration within the particular industry. An industry is considered highly concentrated by the Department if the four largest firms control 75% or more of the total market. In such a market, the Department considers a merger illegal if it involves two companies each with 4% of the market although, in a less concen-

otherwise in violation of section 7 will be permitted if the defendant<sup>6</sup> can satisfy the requirements of the failing company doctrine.<sup>7</sup> Under the doctrine, the defendant must first show that the financial resources of one of the merging companies were so depleted and its chances of rehabilitation so remote that failure was a grave probability in the absence of a merger. Second, the defendant must prove that the competitor who purchased the failing company was the only available purchaser.<sup>8</sup> Once these elements are proven, an absolute defense to the charge of a section 7 violation is established.<sup>9</sup>

In *United States v. General Dynamics Corp.*,<sup>10</sup> the Supreme Court was faced with a defense to an alleged violation based on failing physical resources rather than failing finances. Although the Court discussed the failing company doctrine, it did not decide the case on the basis of that defense. The Court instead adopted a new approach to section 7 cases by creating a more stringent standard of proof for the Government and a new defense for merging companies.<sup>11</sup> Although the Court clearly distinguished its holding from the failing company doctrine,<sup>12</sup> commentators have subsequently debated the effect of *General Dynamics* on the doctrine.<sup>13</sup> Moreover, some courts have ignored the distinction between the two defenses.<sup>14</sup> As a result, the continued existence of the doctrine as a viable and useful defense has been called into question.

This Note will examine the failing company doctrine and the *General Dynamics* defense as they apply to horizontal mergers and will conclude that the two defenses are totally distinct in purpose, elements, and application. Part I will discuss the standard of proof that had been required of the Government in section 7 cases prior to *General Dynamics* and the development of the failing company doctrine. Part II will examine the holding in *General Dynamics*, its subsequent application in section 7 cases, and its effect on recent failing company

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trated industry, a combined firm holding 8% of the market might be acceptable. The Department also applies another standard to determine if there is a trend toward greater concentration in the particular market. This trend is considered to be present if the aggregate market share of the largest firms, ranging anywhere in number from two to eight, had increased by approximately 7% or more from any base year five to ten years prior to the merger. Finally, even where the merger does not come within these requisite standards of market share and concentration, the Department may still challenge it if the merger or acquisition is particularly "disturbing" or "disruptive," or if the merger involves a firm with an insubstantial market share but which owns a particularly valuable asset that confers an unusual competitive advantage, such as a patent. Merger Guidelines, *supra* note 2, at 6883-84.

6. Both the acquiring and the acquired companies generally are named as defendants in § 7 cases. Unless otherwise specified, the use of the term "defendant" in this Note will refer to the acquiring company.

7. See pt. I(B) *infra*.

8. See *United States v. Black & Decker Mfg. Co.*, 430 F. Supp. 729, 781-82 (D. Md. 1976); *United States v. M.P.M., Inc.*, 397 F. Supp. 78, 101-02 (D. Colo. 1975); P. Areeda & D. Turner, III *Antitrust Law* ¶ 701h, at 108 (1978); A. Austin, *Antitrust: Law, Economics, Policy* § 9.11 (1976).

9. See note 132 *infra* and accompanying text.

10. 415 U.S. 486 (1974), discussed at pt. II(A) *infra*.

11. *Id.* at 497-501, 508.

12. *Id.* at 507-08. For a discussion of this distinction, see pt. III *infra*.

13. See notes 73-75 *infra* and accompanying text.

14. See notes 86-100 *infra* and accompanying text.

doctrine decisions. Part III will analyze and compare the purposes and elements of the two defenses, and examine how some courts have confused them. Finally, Part IV will discuss the traditional application of the failing company doctrine and propose that a modification of the doctrine will more properly effectuate its purpose.

## I. THE LAW PRIOR TO *General Dynamics*

### A. *The Government's Prima Facie Case*

The language of section 7 compels the Government to satisfy several requirements in order to establish a prima facie case with respect to a horizontal merger. First, the Government must define the relevant market that will be affected by the merger. The relevant market consists of a product market, which is the line of commerce or type of product involved in the merger, and a geographic market, which is the area of the country in which the products are sold.<sup>15</sup> Once the relevant market is defined, the Government must prove that the merger would probably lessen competition substantially or tend to create a monopoly within that market.<sup>16</sup>

In *Brown Shoe Co. v. United States*,<sup>17</sup> the Supreme Court, analyzing the language of section 7, announced that in order to prove that a merger would substantially lessen competition, the Government would be required to present an examination of each merger within the context of the structure, history, and future of the industry.<sup>18</sup> The Government also had to present evidence of other factors, such as increasing concentration in the industry, difficulty of entry into the industry, and foreclosure of suppliers and buyers within the industry.<sup>19</sup> A

15. See, e.g., *United States v. E. I. du Pont de Nemours & Co.*, 353 U.S. 586, 593-94 (1957); L. Sullivan, *supra* note 2, § 203, at 605-12.

16. The phrasing of the statute, *see* note 3 *supra*, also requires the Government to show that the acquired and acquiring firms are engaged in actual or potential competition, and that the merger affects the structure of competition within the market to an "unacceptable degree." L. Sullivan, *supra* note 2, § 202, at 601; *see, e.g., Brown Shoe Co. v. United States*, 370 U.S. 294, 335 (1962).

17. 370 U.S. 294 (1962). The merger in *Brown Shoe* was both horizontal and vertical. The acquiring company was primarily a shoe manufacturer, but also had a substantial number of retail shoe outlets. The acquired company was principally engaged in the sale of shoes, but also owned four shoe factories. The combined firm controlled almost 1600 shoe outlets and from 5% to 57% of the retail market in cities where these outlets were located. *Id.* at 342-45.

18. *Id.* at 321-22.

19. *Id.* at 322. An important factor in determining the level of competition in an industry is the ease or difficulty with which a firm may enter the market. Examples of barriers to easy entry include large startup costs, such as the costs of advertising, the need to provide a variety of products, and regulatory restrictions. If barriers to entry are high, relatively few firms will attempt to enter the market, and firms already in the industry may act more often in collusive and anticompetitive ways. If, however, barriers to entry are low and new firms can enter the market easily, this prevents firms already in the industry from behaving in anticompetitive ways because of the threat that a new company will enter the market and charge more competitive prices. *See* L. Sullivan, *supra* note 2, § 205, at 633-34; Comment, *Horizontal Mergers After United States v. General Dynamics Corp.*, 92 Harv. L. Rev. 491, 504-06 (1978) [hereinafter cited as *Horizontal Mergers*]. A merger may also result in preventing outside suppliers from selling to former customers within an industry that are now part of another company. Similarly, once a company has merged, it may be foreclosed from dealing with buyers and suppliers of its choice. 370 U.S. at 322.

year later in *United States v. Philadelphia National Bank*,<sup>20</sup> however, the Court streamlined the complicated economic inquiry that it had established in *Brown Shoe*. While still maintaining that an inquiry into many economic factors was relevant to the issue of illegal mergers, it stated that such an examination was so complex and cumbersome that it might serve to defeat the congressional purpose of halting increased economic concentration in the country.<sup>21</sup> To avoid this, the Court held that the Government could make a prima facie showing of illegality based solely on statistics proving that a merger had produced a company with an "undue percentage share" of the market and had significantly increased concentration in the industry.<sup>22</sup> The Court did not overrule *Brown Shoe* completely, but adopted a more simplified test of illegality in all cases in which its use would not contravene the purpose of section 7.<sup>23</sup> Despite this caveat, the Court consistently applied the *Philadelphia National Bank* test in all subsequent section 7 merger cases with the result that the test became the accepted standard.<sup>24</sup>

After the Government satisfied its standard of proof, the defendant had the burden of proving either that the Government's statistics were inaccurate or that, despite the accuracy of the figures, other factors indicated that the merger would have no substantial anticompetitive effects.<sup>25</sup> If the defendant could not overcome the Government's prima facie case by one of these two methods, its only alternative was to use the affirmative defense of the failing company doctrine.<sup>26</sup>

### B. The Failing Company Doctrine

The failing company doctrine was first announced by the Supreme Court in 1930 in *International Shoe Co. v. FTC*.<sup>27</sup> The International Shoe Company had acquired nearly all the capital stock of the McElwain Company, which was on

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20. 374 U.S. 321 (1963). The case involved the merger of two banks that were the second and third largest commercial banks located in the Philadelphia metropolitan area. The combined firm would have controlled 30% of the relevant market. *Id.* at 364.

21. *Id.* at 362-63.

22. *Id.* at 363.

23. *Id.* at 362.

24. L. Sullivan, *supra* note 2, § 200, at 594-95. The use of this standard of proof that emphasized a statistical showing of increased concentration resulted in mergers being declared illegal even where the resulting company controlled only a small share of the market. For example, in *United States v. Von's Grocery Co.*, 384 U.S. 270 (1966), the Court declared illegal a merger that resulted in a 7.5% share of the retail grocery market in Los Angeles because the Government had made a showing of increased concentration in the industry. *Id.* at 278-79, 281; *accord*, *United States v. Pabst Brewing Co.*, 384 U.S. 546, 550 (1966) (combined firms held 4.5% of the market); *United States v. Continental Can Co.*, 378 U.S. 441, 461 (1964) (combined firms held 25% of the market); *United States v. Aluminum Co. of America*, 377 U.S. 271, 278 (1964) (combined firms held 17% of the aluminum conductor market). This trend led Justice Stewart to declare that "[t]he sole consistency . . . in litigation under § 7 [is that] the Government always wins." *United States v. Von's Grocery Co.*, 384 U.S. at 301 (Stewart, J., dissenting).

25. See L. Sullivan, *supra* note 2, § 204, at 622-23.

26. The failing company doctrine is the only affirmative defense available to a defendant in a § 7 case. *Id.* § 204, at 628-31; *Horizontal Mergers*, *supra* note 19, at 498; see notes 39-40 *infra* and accompanying text.

27. 280 U.S. 291 (1930).

the brink of bankruptcy because of a lack of new orders, mounting operating losses, and an inability to pay debts as they came due.<sup>28</sup> Although both firms manufactured shoes, ninety-five percent of their sales were in different areas of the country and involved different styles of shoes.<sup>29</sup> The Court held that there was no violation of section 7 for two reasons. First, there had been no substantial competition between the two companies prior to the merger,<sup>30</sup> and section 7 required that the acquiring and acquired companies be direct competitors in order for the merger to constitute a violation.<sup>31</sup> Second, the Court held that even if there had been substantial competition, there still would have been no violation because McElwain was a failing company.<sup>32</sup> Reviewing only evidence of McElwain's financial performance prior to the merger,<sup>33</sup> the Court found that the company had such depleted financial resources and such dim prospects of rehabilitation that failure was imminent.<sup>34</sup> It also concluded that International Shoe was McElwain's only "prospective purchaser."<sup>35</sup> The Court upheld the merger because it was motivated by a desire to avoid injury to stockholders and to the communities in which the shoe factories were located, and to mitigate whatever other consequences would result from a business failure.<sup>36</sup>

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28. In 1921, at the time of the merger, McElwain owed approximately \$15 million in bank loans and almost \$2 million in accounts payable, and its factories were producing shoes at approximately 15% of their capacity. *Id.* at 300.

29. International Shoe sold 95% of its shoes, consisting mostly of casual and work shoes, in towns with a population of 6000 or less located in the South and West. McElwain sold 95% of its product, which contained an extensive line of dress shoes, in cities with a population of more than 10,000 in the North and East. *Id.* at 295-96.

30. *Id.* at 299.

31. The law governing mergers in 1930 was slightly different from current law. The original Clayton Act applied only to mergers achieved through stock acquisition between companies that were in substantial competition with each other before they merged. Clayton Act, ch. 323, § 7, 38 Stat. 731 (1914) (current version at 15 U.S.C. § 18 (1976)). To prove a violation at the time of *International Shoe*, the Government had to show that there had been substantial competition between the two companies prior to the merger and that the acquisition would have a significant effect on the market structure. D. Martin, *Mergers and The Clayton Act* 127-29 (1959).

32. 280 U.S. at 302-03. There has been some suggestion that this second holding is actually dictum because the Court's first holding dispensed with the basis upon which a violation of § 7 could occur. *See* *United States Steel Corp.*, 74 F.T.C. 1270, 1308 (1968) (Elman, Comm'r., dissenting). The Court in *International Shoe*, however, clearly indicated that it intended to decide the case "for the reasons appearing under *each* of the two foregoing heads of this opinion." 280 U.S. at 303 (emphasis added).

33. The Court's determination of McElwain's future prospects was clearly based on evidence of the company's financial problems prior to the merger and not on evidence of the company's future prospects. For example, the Court discussed McElwain's condition in 1920 and 1921 prior to the merger, when the company sustained losses of more than \$6 million, owed approximately \$15 million to the banks and an additional \$2 million in accounts payable, and could not pay its debts as they came due. 280 U.S. at 299-300.

34. *Id.* at 302. It is clear from the facts of the case that the term "depleted resources" referred to financial resources, not physical resources, because McElwain's manufacturing facilities and present stock of shoes were more than sufficient to meet foreseeable demand and keep the company in business. *Id.* at 299-300.

35. *Id.* at 302. The Court, however, did not indicate that evidence as to the nonavailability of other purchasers had been presented.

36. *Id.*

Between 1930 and 1969, the failing company doctrine was rarely invoked, but the defense was not completely forgotten.<sup>37</sup> In 1950, Congress amended section 7 and expanded the coverage of the Clayton Act.<sup>38</sup> Although Congress eliminated several defenses to section 7 violations,<sup>39</sup> it specifically endorsed the failing company doctrine as enunciated in *International Shoe*.<sup>40</sup> Congress, however, did not make any attempt to clarify the elements of the defense, to state its purpose, or to delineate the scope of its application.

The failing company doctrine next received considerable attention in 1969 when the Supreme Court decided *Citizen Publishing Co. v. United States*.<sup>41</sup> The only two newspapers in Tuscon, Arizona, the *Citizen* and the *Star*, had been vigorous competitors before they entered into a joint operating agreement containing price-fixing, profit-pooling, and market control provisions. They also created a new jointly owned corporation to manage all aspects of their respective businesses except the news and editorial departments.<sup>42</sup> The defendant contended that the *Citizen* was a failing company because it had operated at an average annual loss of \$23,550 prior to the agreement and was able to obtain only

37. *International Shoe* is the only case in which the Supreme Court has found that the elements of the defense have been satisfied. Other cases prior to 1969, however, applied the doctrine. See *Beegle v. Thomson*, 138 F.2d 875, 881 (7th Cir. 1943), *cert. denied*, 322 U.S. 743 (1944); *United States v. Maryland & Va. Milk Producers Ass'n.*, 167 F. Supp. 799, 808 (D.D.C. 1958), *modified*, 362 U.S. 458 (1960); *In re Pressed Steel Car Co.*, 16 F. Supp. 329, 339 (W.D. Pa. 1936).

38. Celler-Kefauver Act, ch. 1184, 64 Stat. 1125 (codified at 15 U.S.C. § 18 (1976)). The new section covers mergers achieved through the acquisition of assets as well as stock, and applies to any substantial reduction in competition, not simply competition between the companies involved in the merger. L. Sullivan, *supra* note 2, § 199, at 592.

In 1976, Congress added § 7a to the Clayton Act. Hart-Scott-Rodino Antitrust Improvement Act of 1976, Pub. L. No. 94-435, § 201, 90 Stat. 1390 (codified at 15 U.S.C. § 18a (1976)). This provision requires merging companies to submit a notice before the merger to both the Justice Department and the Federal Trade Commission and to wait 30 days, or 15 days in the case of a cash tender offer, before consummating the merger. 15 U.S.C. § 18a(a)-(b) (1976). Both the Justice Department and the Commission are empowered to request an injunction if they believe the merger will violate § 7. *Id.* § 18a(f).

39. The Celler-Kefauver Act eliminated two defenses to prosecution under § 7: (1) a claim that assets rather than stock had been purchased, and (2) a claim that there had been no substantial competition between the merging companies prior to the acquisition. S. Rep. No. 1775, 81st Cong., 2d Sess. 2-3, *reprinted in* [1950] U.S. Code Cong. Serv. 4293, 4294-95; see H.R. Rep. No. 1191, 81st Cong., 1st Sess. 4-5 (1949).

40. The Senate Report on the amendments stated: "The argument has been made that the proposed bill, if passed, would have the effect of preventing a company which is in a failing or bankrupt condition from selling out.

"The committee are [*sic*] in full accord with the proposition that any firm in such a condition should be free to dispose of its stock or assets. The committee, however, do [*sic*] not believe that the proposed bill will prevent sales of this type." S. Rep. No. 1775, 81st Cong., 2d Sess. 7 (1950), *reprinted in* [1950] U.S. Code Cong. Serv. 4293, 4299; see H.R. Rep. No. 1191, 81st Cong., 1st Sess. 9 (1949). The failing company defense also received attention from the Senate Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary in 1957, which endorsed the mergers of failing automobile manufacturers for reasons of economic efficiency and as a method to ensure competition against larger companies in the industry. S. Rep. No. 132, 85th Cong., 1st Sess. 41-42 (1957).

41. 394 U.S. 131 (1969).

42. *Id.* at 133-34. The joint operating agreement was signed in 1940 and renewed in 1953. *Id.*

fifty percent of the advertising revenues that the *Star* was enjoying.<sup>43</sup> The Court rejected this argument and narrowed the failing company doctrine by establishing stricter standards than those announced in *International Shoe*. First, the Court limited the definition of "failing" to mean that a company in financial difficulty would have to prove that its prospects for success would be "dim or nonexistent" even if it went through bankruptcy proceedings and reorganization.<sup>44</sup> Second, the Court amended the only prospective purchaser requirement to mean the only available purchaser. This more stringent standard precluded the application of the doctrine if any other possible purchaser existed.<sup>45</sup>

Between *Citizen Publishing* and *General Dynamics*, courts that considered the failing company doctrine did not apply these stricter standards. Although not expressly rejecting *Citizen Publishing*, the courts consistently looked at the performance of the company prior to the merger, not predictions of its future ability to recover after reorganization or postacquisition evidence concerning the effect of the merger on competition.<sup>46</sup> Although the courts used the term "only available purchaser," their decisions indicated that the purchaser need only be the least anticompetitive one.<sup>47</sup> This standard reflected the Justice Department's definition of the second element of the defense, which simply requires "good faith efforts by the failing firm [that] have failed to elicit a reasonable offer of acquisition more consistent with the purposes of Section 7 by a firm which intends to keep the failing firm in the market."<sup>48</sup> In none of these cases, however, was there any discussion of whether proving the two traditional elements automatically established the defense, or whether an additional showing that there were only minimal anticompetitive effects was necessary. Instead, the courts seem to have assumed that once the elements of the defense were proven, the defense was

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43. *Id.* at 133.

44. *Id.* at 138. Prior to *Citizen Publishing*, courts had not used a particular standard or test for determining when a company was failing. In *International Shoe*, the deciding factor seems to have been the equitable insolvency of the acquired company. See 280 U.S. at 299-300. One author has noted that the courts have used a variety of tests, including (1) the existence or absence of a profit, (2) the ability to remain in business absent a merger, (3) the ability to raise capital, and (4) rising or falling sales. Low, *The Failing Company Doctrine: An Illusive Economic Defense Under Section 7 of the Clayton Act*, 35 Fordham L. Rev. 425, 437-42 (1967) [hereinafter cited as *Illusive Defense*].

45. 394 U.S. at 138. The Court reasoned that if another company were interested, "a unit in the competitive system would be preserved and not lost to monopoly power." *Id.* This reasoning is unclear. It would seem that the Court was arguing that the presence of another interested purchaser probably would indicate that the failing company still had some competitive value and that its acquisition would have some anticompetitive effect. Application of the failing company doctrine, however, does not prohibit all anticompetitive mergers, see notes 112-14 *infra* and accompanying text, and it seems logical that any court applying this exception to § 7 would only be interested in whether the purchaser had the least impact on competition.

46. See *United States v. Greater Buffalo Press, Inc.*, 402 U.S. 549, 555 (1971); *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1258-61 (C.D. Cal. 1973), *aff'd*, 418 U.S. 906 (1974); *United States v. G. Heileman Brewing Co.*, 345 F. Supp. 117, 122-23 (E.D. Mich. 1972).

47. See, e.g., *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1260 (C.D. Cal. 1973), *aff'd*, 418 U.S. 906 (1974).

48. See Merger Guidelines, *supra* note 2, at 6884. These guidelines were first promulgated by the Justice Department in 1968 and are still in effect. They do not, however, have the force of law. L. Sullivan, *supra* note 2, § 204, at 620 n.27.



absolute and there could be no violation of section 7 despite the magnitude of the merger's effect on competition.<sup>49</sup>

## II. *General Dynamics* AND ITS AFTERMATH

### A. *The General Dynamics Decision*

The Supreme Court's 1974 decision in *United States v. General Dynamics Corp.*<sup>50</sup> stands as a landmark decision in horizontal merger cases, not only because it was the first such case that the government had lost on the merits since the 1950 amendments to the Clayton Act, but also because the case established a strict standard of proof for the Government in section 7 cases.<sup>51</sup> In 1959, the Material Service Corporation, a multi-industry company that owned a deep-mining coal company, acquired the United Electric Coal Company, a strip-mining coal firm that operated in the same geographic area. Several months later, Material itself was acquired by the General Dynamics Corporation, a conglomerate whose main business was the manufacture and sale of airplanes, communications equipment, and marine products.<sup>52</sup> Although United Electric was a profitable and efficient coal producer, it held only one percent of all the coal reserves in the relevant geographic market.<sup>53</sup> Moreover, between 1959 and 1967, when United Electric became a wholly owned subsidiary of General Dynamics, the actual combined coal production of United Electric and Material had declined.<sup>54</sup> The Government brought suit under section 7 to force General Dynamics to divest itself of United Electric on the grounds that the coal industry by 1967 had become highly concentrated among a small number of large companies, and

49. Blum, *The Failing Company Doctrine*, 16 B.C. Indus. & Com. L. Rev. 75, 94 (1974).

50. 415 U.S. 486 (1974).

51. Because of this strict standard of proof, the Government has lost half of the horizontal merger cases that it has brought since the *General Dynamics* decision. See *United States v. International Harvester Co.*, 564 F.2d 769 (7th Cir. 1977); *United States v. Consolidated Foods Corp.*, 455 F.Supp. 108 (E.D. Pa. 1978); *United States v. Culbro Corp.*, 436 F. Supp. 746 (S.D.N.Y. 1977); *United States v. Federal Co.*, 403 F. Supp. 161 (W.D. Tenn. 1975); *United States v. M.P.M., Inc.*, 397 F.Supp. 78 (D. Colo. 1975). This trend can be attributed to the courts' growing interest in examining business and economic realities rather than emphasizing purely statistical evidentiary requirements, an interest that was spurred by *General Dynamics*. It also may be a reaction to the antitrust cases of the 1960's in which the Government always won, based on the *Philadelphia National Bank* standard of proof. Fox, *Antitrust, Mergers, and the Supreme Court: The Politics of Section 7 of the Clayton Act*, 26 Mercer L. Rev. 389, 396 (1975); Robinson, *Recent Antitrust Developments: 1974*, 75 Colum. L. Rev. 243, 244 (1975); see note 24 *supra*.

Recently, a broad reevaluation of the nature and purposes of the antitrust laws has been developing concerning such questions as the economic desirability of mergers, the standard of proof to be required of the government, and problems arising from conglomerate mergers. See Address by John H. Shenefield, Assistant Attorney General, Antitrust Division, Graduate School of Business, University of Chicago (Oct. 25, 1978), reprinted in 1978 Department of Justice Releases (Oct.-Dec.). As a result of this reevaluation, the Justice Department is anticipating an "enormous number of mergers" in the coming months and has announced its intention to crack down on such merger activity through closer scrutiny and more aggressive prosecution of possible offenders. Wall St. J., Oct. 12, 1978, at 2, col. 3.

52. 415 U.S. at 488-89.

53. *Id.* at 502, 507.

54. *Id.* at 496.

that Material's acquisition of United Electric had caused even greater concentration. The Government also contended that United Electric and Material's deep-mining coal company were direct competitors in the production and sale of coal in the relevant markets, and that the acquisition therefore had greatly increased Material's market share in the coal industry.<sup>55</sup> Following the standard of proof established in *Philadelphia National Bank*,<sup>56</sup> the Government presented statistics of past sales and production for both companies and established a prima facie case of increased market share and concentration.<sup>57</sup>

The Court held that the Government's statistical case was insufficient to prove a violation for two reasons. First, the Court held that the proper measure of each company's market share was to be determined not by examining past production and sale of coal, but rather by examining coal reserves, which were small and rapidly dwindling.<sup>58</sup> Second, the Court noted that even if the Government's statistics had been accurate, they were insufficient to show a violation in the face of broader evidence of market structure presented by the defendant indicating that the number of coal producers was declining because of a changing demand for coal, not because of any anticompetitive activities by large producers.<sup>59</sup> The evidence also demonstrated that Material and United Electric were "predominantly complementary in nature," as opposed to competitive, and, with one exception, did not sell to the same consumers.<sup>60</sup> Finally, the Court held that the merger was lawful because United Electric lacked sufficient reserves to compete effectively for long-term supply contracts with utility companies, which constituted the main source of business for coal firms in the relevant market.<sup>61</sup>

The Court in *General Dynamics* rejected the standard of proof established in *Philadelphia National Bank* insofar as that standard required only a statistical showing of increased concentration and market share, and required the Government in a section 7 suit to introduce broader evidence of other economic considerations.<sup>62</sup> While the Court recognized the importance of such statistics, it made clear that, as had been stated earlier in *Brown Shoe*, statistics are by no means conclusive and that every merger must be viewed within the context of the nature and history of its industry in order to determine its effect on competi-

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55. *Id.* at 490, 494-96.

56. See notes 20-24 *supra* and accompanying text.

57. 415 U.S. at 494-96. These statistics revealed that between 1957 and 1967, the years the Government chose to study, the top two firms in Illinois had increased their share of the market from 37.8% to 52.9%, and the top ten firms had increased their share from 84% to 98%. In addition, the number of coal producers in Illinois had decreased 73% from 144 to 39. *Id.*

58. "In this situation, a company's past ability to produce is of limited significance, since it is in a position to offer for sale neither its past production nor the bulk of the coal it is presently capable of producing, which is typically already committed under a long-term supply contract. A more significant indicator of a company's power effectively to compete . . . lies in . . . a company's uncommitted reserves of recoverable coal." *Id.* at 501-02.

59. *Id.* at 498-99.

60. *Id.* at 493 (quoting *United States v. General Dynamics Corp.*, 341 F. Supp. 534, 558 (N.D. Ill. 1972)). While the Supreme Court based its decision primarily on a lack of reserves, the district court had based its holding primarily on the fact that Material's deep-mining company and United Electric were not actual or potential competitors. *United States v. General Dynamics Corp.*, 341 F. Supp. 534, 558-59 (N.D. Ill. 1972).

61. 415 U.S. at 503.

62. *Id.* at 498; see *Horizontal Mergers*, *supra* note 19, at 501-02.

tion.<sup>63</sup> If the Government presents statistics of increased market shares and concentration, the defendant may overcome the *prima facie* case with broader evidence proving that those statistics do not represent accurately the true effect of the merger on the relevant market and that there have been no substantial anticompetitive effects.<sup>64</sup> As the defense was applied to the facts of the case, the defendant prevailed for two reasons. First, it proved that the acquired company lacked the ability to continue to compete effectively with other firms at the "focus of competition,"<sup>65</sup> the point at which companies in an industry vie with one another for as great a market share as they can obtain. The focus of competition in *General Dynamics* was not on the past disposition of coal already produced and sold, but on the company's future ability to obtain new long-term supply contracts.<sup>66</sup> Second, the Court held that the acquired company's inability to compete was due to a lack of the physical resource necessary for it to operate successfully.<sup>67</sup> In establishing this defense, the defendant was permitted to introduce evidence showing postacquisition developments in the structure of the particular industry because these facts were not subject to manipulation by the merging companies. These broader factors had developed independently because of a variety of forces, not just one merger, and therefore could be properly considered in determining the effect of the merger on competition.<sup>68</sup>

The Court in *General Dynamics* stated that its holding was not intended to affect the failing company doctrine in any way. The Court noted that the purpose of the failing company doctrine was intended to be "a 'lesser of two evils' approach, in which the possible threat to competition resulting from an acquisition is deemed preferable to the adverse impact on competition and other losses if the company goes out of business."<sup>69</sup> In contrast, the purpose of *General Dynamics* was to establish a new standard of proof for the Government and a new defense for the merging companies in cases in which the merger had no anticom-

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63. 415 U.S. at 498. Applying a *Brown Shoe* analysis, the Court found that since World War II, coal had been increasingly unable to compete with other sources of energy, that the electric utilities had become the main consumers of coal, and that nearly all coal sold to these utilities was sold under long-term supply contracts. *Id.* at 499.

64. See note 76 *infra* and accompanying text.

65. 415 U.S. at 501.

66. See note 58 *supra* and accompanying text.

67. 415 U.S. at 501-03.

68. *Id.* at 506. The use of postacquisition evidence in § 7 cases is a complex problem. When, as in *General Dynamics*, a long time has passed between the merger and the Government's suit, evidence might be taken at trial as of the time of the merger, the time the suit was filed, or the time of trial. Which time is chosen may have a significant effect on the case because concentration ratios, market shares, and general conditions may change over the course of even a few years. L. Sullivan, *supra* note 2, § 204, at 626. Furthermore, the Supreme Court has held that there is no statute of limitations governing the time in which the Government must bring suit under § 7. A merger that seems lawful when made can later be challenged on the basis of evidence of postacquisition developments that have occurred that show the probability of anticompetitive effects. *United States v. E. I. du Pont de Nemours & Co.*, 353 U.S. 586, 597, 602 (1957). Courts consider the defendant's use of such evidence to show the lack of anticompetitive effects after the merger to be unreliable, however, because the acquiring firm may remain on its best behavior for several years after the merger simply to avoid suit. See *FTC v. Consolidated Foods Corp.*, 380 U.S. 592, 598 (1965); *United States v. Continental Can Co.*, 378 U.S. 441, 463 (1964).

69. 415 U.S. at 507 (footnote omitted).

petitive effects. Applying this standard, the Court held that the defendant's evidence did not go to a failing company defense, but rather went solely to the weakness of the Government's case that "[t]he failing-company defense is simply inapposite to this finding . . . ." <sup>70</sup>

The dissent in *General Dynamics* contended that the Court had allowed itself to be persuaded by the defendant's inadequate attempt to establish a failing company defense. <sup>71</sup> The dissent argued that the attempt was inadequate because the defendant had relied heavily on postacquisition evidence and had failed to satisfy either of the two elements of the defense, and therefore the Government's *prima facie* case was conclusive. <sup>72</sup>

The disagreement among the members of the Court concerning the significance of *General Dynamics* was reflected in subsequent commentary on the case. One writer saw the case as a reaffirmation of the Government's standard of proof originally set forth in *Brown Shoe*. <sup>73</sup> Another interpreted the decision as creating a totally new defense to section 7 that was applicable to companies that were financially healthy but suffering from "a latent terminal illness." <sup>74</sup> Finally, there was a suggestion that, after *General Dynamics*, the failing company doctrine had been eliminated and was now only "a piece of excess baggage." <sup>75</sup>

#### B. *Effect of General Dynamics on Failing Company Doctrine Cases*

Since 1974, the Supreme Court and lower courts have applied the decision in *General Dynamics* by holding that the Government's statistical case is not conclusive, but merely a first step in proving a violation of section 7. <sup>76</sup> The courts subsequently have differed, however, over the problem of how to apply the failing company doctrine in light of *General Dynamics*. Some courts have clearly distinguished the doctrine from *General Dynamics* and applied it in its traditional form. <sup>77</sup> In determining if the elements of the doctrine have been satisfied,

70. *Id.* at 508.

71. *Id.* at 523 (Douglas, J., dissenting).

72. *Id.* at 523-25 (Douglas, J., dissenting).

73. 24 Drake L. Rev. 223, 230-31 (1974).

74. 27 U. Fla. L. Rev. 281, 286 (1974).

75. Robinson, *Recent Antitrust Developments: 1974*, 75 Colum. L. Rev. 243, 251 (1975). Robinson also suggested that *General Dynamics* should be limited to its facts and only applied in § 7 cases concerning extractive industries. *Id.* at 246.

76. *United States v. Citizens & S. Nat'l Bank*, 422 U.S. 86, 120 (1975); *United States v. Marine Bancorporation*, 418 U.S. 602, 631 (1974); *United States v. International Harvester Co.*, 564 F.2d 769, 773-74 (7th Cir. 1977); *United States v. Consolidated Foods Corp.*, 455 F. Supp. 108, 135 (E.D. Pa. 1978); *United States v. Federal Co.*, 403 F. Supp. 161, 167, 171 (W.D. Tenn. 1975); *United States v. Amax, Inc.*, 402 F. Supp. 956, 970-71 (D. Conn. 1975). The defendant can prove that the Government's figures do not accurately reflect the economic structure of the market in one of three ways. First, it can show that the statistics are inaccurate and irrelevant because they are not a true measure of market share. *See, e.g., United States v. Amax, Inc.*, 402 F. Supp. at 961-62, 974. Second, the defendant may prove that although the statistics are accurate, they do not accurately reflect market conditions. *See, e.g., United States v. Citizens & S. Nat'l Bank*, 422 U.S. at 120-22. Third, a defendant might show that one of the merger partners was so weak that its acquisition had no substantial effect on competition. *See, e.g., United States v. International Harvester Co.*, 564 F.2d at 773; *see notes 86-100 infra* and accompanying text. For a detailed discussion of the application of the *General Dynamics* defense, *see Horizontal Mergers, supra* note 19.

77. As in the failing company cases decided between 1959 and 1974, these recent cases have not

these courts have considered only premerger evidence and not events that occurred after the acquisition.<sup>78</sup> For example, in *United States v. M.P.M., Inc.*,<sup>79</sup> the failing company doctrine was upheld when two small manufacturers and sellers of ready-mix concrete merged after one of them had suffered a near financial collapse.<sup>80</sup> The defendant showed that one of the firms had clearly been a failing company prior to the merger because it had experienced a large loss of profits, a precipitous drop in operating capital, loss of a credit line, and a resulting inability to meet obligations as they came due.<sup>81</sup> The purchaser was also the only one of twelve potential purchasers who had not refused to buy the company when offered the opportunity.<sup>82</sup> Similarly, in *United States v. Black & Decker Manufacturing Co.*,<sup>83</sup> although the acquired company was found to be failing,<sup>84</sup> the court refused to apply the doctrine because the defendant had failed to prove that there had been a good faith search for an alternative purchaser.<sup>85</sup>

The Seventh Circuit, however, has recently confused the *General Dynamics*

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adhered to the stricter requirements of *Citizen Publishing*. See notes 41-49 *supra* and accompanying text.

78. See note 122 *infra* and accompanying text.

79. 397 F. Supp. 78 (D. Colo. 1975).

80. The companies involved in this horizontal merger were the third and fourth largest suppliers of ready-mix concrete in a four-county area. After the merger, they became the largest supplier. *Id.* at 83.

81. *Id.* at 99-101.

82. *Id.* at 101-02.

83. 430 F. Supp. 729 (D. Md. 1976). Black and Decker, a manufacturer of electric drills, had acquired the McCulloch Corporation, a small manufacturer of gasoline-powered chainsaws that distributed its products nationwide. Because the two companies did not share the same relevant product market, this merger was a product extension merger. See note 2 *supra*. The Government's claim of a § 7 violation was based on a potential competition theory. *Id.* at 733-35. This theory rests on a concept that firms within an industry do not set prices at a level much higher than the competitive price for fear that another firm, not presently within the market but equipped to overcome the entry barriers, will move into the industry and offer its products at lower, more competitive prices. The anticipation of potential competition keeps actual firm activity at a more competitive level than it would otherwise attain. See L. Sullivan, *supra* note 2, § 205, at 633-34. The Government argued that Black and Decker had maintained a certain level of competition in the gasoline-powered chainsaw industry by being both an actual potential entrant, in that it was able to enter the industry, and also a perceived potential entrant in that other firms already in the industry were expecting Black and Decker to enter the market sometime in the future. 430 F. Supp. at 733-34. Therefore, by moving into the industry through the acquisition of McCulloch, the larger company had lessened potential as well as actual levels of competition. *Id.* at 755-73. For a more detailed discussion of this theory, see L. Sullivan, *supra* note 2, § 205, at 633-44.

84. 430 F. Supp. at 781. The court based its decision upon evidence showing an increase in net losses of the acquired company, deterioration of its retained earnings, loss of its working capital, and an inability to pay its debts to its bank and suppliers as the debts came due. *Id.* at 779-81.

85. *Id.* at 781-82. There was no evidence that McCulloch had made any attempt to locate a purchaser other than Black and Decker. In fact, McCulloch had actually turned away one interested company. McCulloch had argued that its loan agreement with the bank that supplied it with credit precluded any merger partner other than Black and Decker because the bank had conditioned its waiver of loan defaults on merger with the larger company. The court, however, rejected this argument, stating that the bank had not made a merger with Black and Decker a condition to waiving the loan defaults until a month before the merger, giving McCulloch several months prior to the loan agreement in which to locate another purchaser. *Id.*

defense with the elements of the failing company doctrine. In *United States v. International Harvester Co.*,<sup>86</sup> the alleged violation consisted of a stock purchase agreement and a contract to supply tractors between two companies that competed in the manufacture and sale of farm tractors.<sup>87</sup> The Government presented a prima facie case of illegality based on concentration ratios and market shares within the relevant market,<sup>88</sup> and argued that the defendant could not use a *General Dynamics* defense because it had sufficient physical resources to continue to compete in the market.<sup>89</sup> The Government also contended that the failing company defense was not applicable because the acquired company, prior to the merger, had been unable only to obtain sufficient funds to expand its present operation, and its financial condition was actually improving at the time that the agreements were signed.<sup>90</sup> Although the defendant expressly declared that it was not relying on the failing company doctrine,<sup>91</sup> it organized its evidence and arguments into two sections bearing a close resemblance to the elements of that defense. First, the defendant introduced evidence concerning the company's financial condition in an effort to prove financial weakness. It then introduced evidence demonstrating that International Harvester was the only acceptable source of financing available.<sup>92</sup> The defendant also contended that the agreements between the two companies did not constitute a violation of section 7 because there had been only procompetitive effects from the merger.<sup>93</sup>

Relying on *General Dynamics*, the court held in favor of the defendant.<sup>94</sup> The court reasoned that the *General Dynamics* defense was not limited to cases in which there was an absence of physical resources, but also applied whenever special circumstances or any evidence indicated that the Government's statistics did not accurately reflect the effects of the merger on competition.<sup>95</sup> According to

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86. 564 F.2d 769 (7th Cir. 1977).

87. The agreements were between International Harvester, a manufacturer of agricultural, industrial, and construction equipment, and one of its suppliers, Steiger Tractor, Inc., a small manufacturer of four-wheel drive farm tractors that also competed with International Harvester directly by selling some of its tractors to consumers at the retail level. The agreements provided for International Harvester to acquire 39% of Steiger's stock, to gain three seats on Steiger's board of directors, to obtain a veto power concerning any major corporate activities, and to receive 48% to 52% of Steiger's annual production between 1974 and 1979. *Id.* at 771. Because § 7 by its wording applies to the acquisition of part as well as all of a company's stock, *see* note 3 *supra*, the Government argued that these agreements constituted a violation because International Harvester had acquired enough stock to influence and control Steiger's business decisions. The court, however, found that no such control had been exercised. 564 F.2d at 777.

88. 564 F.2d at 774-75.

89. *Id.* at 773 n.7.

90. *Id.* at 775 n.12; *see* Pre-Trial Brief for Plaintiff at 16, 62, 64-65, *United States v. International Harvester*, No. C 684 (N.D. Ill. 1976).

91. Pre-Trial Brief for Defendant at 40-41, *United States v. International Harvester*, No. C 684 (N.D. Ill. 1976).

92. *Id.* at 7-11. The defendant first presented evidence that Steiger was operating at a loss shortly before the stock acquisition, had an extremely low net worth, and a debt-equity ratio well below the industrial average. The defendant then enumerated the various financial institutions that it had approached for funds unsuccessfully, including banks, investment companies, and venture capital groups. *Id.*

93. *Id.* at 16-21, 38.

94. 564 F.2d at 773-74.

95. *Id.* at 773 n.7.

this interpretation, the elements of the *General Dynamics* defense had been met. First, one of the merger partners was in a weakened financial condition, manifested by an inability to withstand economic adversity, thereby placing it at a competitive disadvantage with other firms in the industry.<sup>96</sup> Second, the actual purchaser was the only practical source of financing that would solve the pressing need for capital for the acquired company.<sup>97</sup>

The court's reliance on *General Dynamics* was misplaced and the defense that it actually applied was a lenient version of the failing company doctrine. Unlike United Electric in *General Dynamics*, which was unable to compete because of a lack of resources, the weakened company in *International Harvester* had finances adequate for present operations and it lacked only the money to finance expansion. Indeed, once the acquiring company provided the needed capital, this "failing" company was able to expand its production facilities and thus increase its market share.<sup>98</sup> The court used this evidence of increased market share and the resulting increase in market share of International Harvester as evidence of procompetitive effect of the merger.<sup>99</sup> The acquiring company also was not proven to be the only available one, but only the most practical source for obtaining desired funds.<sup>100</sup> By using the failing company and *General Dynamics* defenses interchangeably in this manner, the court in *International Harvester* ignored the fundamental differences between the two defenses and created an analytical bridge between them that was not meant to exist.

### III. COMPARISON OF THE FAILING COMPANY DOCTRINE AND THE *General Dynamics* DEFENSE

Both the failing company doctrine and the *General Dynamics* defense permit mergers when one of the companies is no longer able to survive as an independent unit in its industry. At this point, the similarity ends. The defenses are completely distinct in purpose and elements, and are designed to apply in different factual circumstances. Whereas *General Dynamics* is concerned only with the proper method of determining whether a merger will have anticompetitive effects, the failing company doctrine is primarily concerned with assessing the adverse business effects that occur when a company fails.

#### A. Purpose

The purpose of *General Dynamics* was to require the Government's prima facie case to present more than just statistical evidence of increased market share and concentration, and to allow a defense to be raised when the Government's statistics do not accurately or fully reflect the effects of the merger on the relevant market. The case merely changes the type and extent of evidence that the Government must present in order to prove a violation, and is not intended to

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96. *Id.* at 774.

97. *Id.* at 779.

98. Steiger's market share increased from 15.9% to 22.4% in the two years following the agreements. *Id.* at 778.

99. *Id.* at 777-78.

100. See note 97 *supra* and accompanying text.

permit anticompetitive mergers.<sup>101</sup> The merger in *General Dynamics* had no anticompetitive effects because, even though the acquired company was operating profitably at the time of the merger, it lacked the physical resources to continue to compete in the future.<sup>102</sup> Although the acquiring company had gained valuable assets such as mining facilities and long-term contracts with customers of the acquired firm,<sup>103</sup> acquisition of these assets alone would not increase its market share without additional coal to mine and sell.<sup>104</sup> The potential effect on competition therefore depended not on the merger itself, but on the possibility of acquiring more coal in the future.<sup>105</sup> Because section 7 applies only when there is a probability that the merger will lessen competition substantially,<sup>106</sup> the mere possibility that more coal could be acquired was held to be too remote to come within the purview of a law concerned with probable anticompetitive effects.<sup>107</sup>

For many years, the purpose of the failing company doctrine was never clearly defined. Although no reason for the doctrine was expressly given in *International Shoe*, the Court seemed to have been concerned with forestalling business failure in order to protect the interests of stockholders, employees, and the communities in which the shoe factories were located.<sup>108</sup> When Congress endorsed the doctrine while enacting the 1950 amendments to the Clayton Act,<sup>109</sup> however, it made no attempt to define or explain the rationale of the defense.<sup>110</sup> Courts and commentators frequently have stated that the defense was allowed because a merger between a healthy company and a failing company cannot substantially lessen competition.<sup>111</sup> This reasoning, however, ignores the many situations in which the acquisition of a company with failing finances can have substantial anticompetitive effects. A company that is not operating profitably because of financial difficulties may still have the physical resources and assets to compete in the future if it can solve its monetary problems. The company will be attractive to any purchaser that has the funds to revitalize it because, after revitalization,

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101. See *United States v. Citizen & S. Nat'l Bank*, 422 U.S. 86, 120-21 (1975); *United States v. General Dynamics Corp.*, 415 U.S. 486, 511 (1974); *United States v. Consolidated Foods Corp.*, 455 F. Supp. 108, 135 (E.D. Pa. 1978); *United States v. Federal Co.*, 403 F. Supp. 161, 170-71 (W.D. Tenn. 1975).

102. 415 U.S. at 507-08.

103. *Id.* at 511.

104. See *id.* at 501-04, 508-09; R. Posner, *Antitrust Law* 109 (1976).

105. 415 U.S. at 509-10.

106. See *Brown Shoe Co. v. United States*, 370 U.S. 294, 323 & n.39 (1962); *United States v. E. I. du Pont de Nemours & Co.*, 353 U.S. 586, 598 (1957); *Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346, 356-67 (1922).

107. 415 U.S. at 509-10.

108. 280 U.S. at 302.

109. See note 40 *supra* and accompanying text.

110. One writer has even suggested that this congressional endorsement alone is the only logical *raison d'être* for the doctrine. Low, *The Failing Company Doctrine Revisited*, 38 *Fordham L. Rev.* 23, 27-28 (1969); *Illusive Defense*, *supra* note 44, at 427-28.

111. *Brown Shoe Co. v. United States*, 370 U.S. 294, 319 (1962); *United States v. Maryland & Va. Milk Producers Ass'n*, 167 F. Supp. 799, 808 (D.D.C. 1958), *modified*, 362 U.S. 458 (1960); Connor, *Section 7 of the Clayton Act: The "Failing Company" Myth*, 49 *Geo. L.J.* 84, 92 (1960); *Illusive Defense*, *supra* note 44, at 427-30; von Kalinowski, *Section 7 and Competitive Effects*, 48 *Va. L. Rev.* 827, 841 (1962).



the acquiring company can expand its own market share at least to the extent of the market share of the company it had acquired. Such a merger, therefore, can have significant anticompetitive effects if either merger partner had an appreciable share of the market prior to the acquisition.<sup>112</sup>

The purpose of the failing company doctrine was clearly expressed for the first time in *General Dynamics*, in which it was defined as a "lesser of two evils" approach that presupposed that the adverse effects of a company's failure are more detrimental than the anticompetitive effects of a merger.<sup>113</sup> The result of this purpose, unlike that of *General Dynamics*, is to allow mergers even though there may be substantial anticompetitive results. The economic losses caused by a business failure may include the loss of investment for shareholders and creditors, the loss of jobs for employees, the loss of certain products to consumers, and the general loss of economic activity for the community as a whole.<sup>114</sup>

### B. Elements

The elements of the two defenses are also completely distinct. To a certain extent, the substance of a *General Dynamics* defense depends on the specific deficiencies in the Government's argument.<sup>115</sup> As applied in the *General Dynamics* decision, the elements of the defense included defining the focus of competition and proof of the lack of necessary physical resources.<sup>116</sup> In all cases in which the *General Dynamics* defense is applied, the need to prove that the acquiring company is the least anticompetitive purchaser is irrelevant<sup>117</sup> because the merger itself has little or no anticompetitive effect. The defendant also may use evidence of postacquisition developments to prove all the elements of the defense.<sup>118</sup>

112. *United States Steel Corp.*, 74 F.T.C. 1270, 1289 (1968), *remanded*, 426 F.2d 592 (6th Cir. 1970); *Illusive Defense supra* note 44, at 428-29; 24 Drake L. Rev. 223, 233 (1974). It has also been argued that the purpose of the defense is to ease a firm's exit from the market in order to make market entry more attractive, particularly for small firms. The basis of this argument is that firms will invest more capital and move into new industries if the risk of losing capital is mitigated, and that the failing company doctrine does operate to mitigate losses. Blum, *supra* note 49, at 84-88. Some writers have asserted that the purpose of the doctrine is to promote economic efficiency, either by providing an inefficient firm with new management to revitalize it, or by simply allowing the inefficient firm to leave the marketplace entirely in a less painful way than through bankruptcy. *Id.* at 88; Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 Harv. L. Rev. 227, 340 (1960).

113. 415 U.S. at 507. In discussing the adverse effects of a business failure, the Court stated that such a failure would have anticompetitive effects, presumably because a business failure creates a vacuum that allows the largest firms in the industry to obtain the assets and market share of the failing firm. It has been argued, however, that allowing a failing company to go out of business rather than to merge is procompetitive, not anticompetitive. *See, e.g.,* R. Posner, *Antitrust Law* 21 (1976).

114. 415 U.S. at 507.

115. *See* note 76 *supra* and accompanying text.

116. *See* notes 65-68 *supra* and accompanying text.

117. The Court in *General Dynamics* did not mention any such requirement. Neither did the court in *United States v. Amax, Inc.*, 402 F. Supp. 956 (D. Conn. 1975), although the Government in that case urged that this element should be added to the *General Dynamics* defense. Post-Trial Brief of Plaintiff at 31.

118. *United States v. General Dynamics Corp.*, 415 U.S. at 506; *see* L. Sullivan, *supra* note 2, § 204, at 627.

The failing company doctrine is an affirmative defense that in no way affects the standard of proof required of the Government. Its elements have been unchanged by *General Dynamics*,<sup>119</sup> and recent cases applying the doctrine have continued the trend away from the stringent requirements of *Citizen Publishing*.<sup>120</sup> In determining whether a company was failing, the courts have not required the defendant to prove that reorganization through bankruptcy would have been unsuccessful, but rather have applied a broad evidence rule, emphasizing the ability of a company to pay its debts as they come due from sources that are continuously available and independent of constant bank financing.<sup>121</sup> In assessing this evidence, courts give little weight to postacquisition evidence.<sup>122</sup> As to the second element of the defense, the cases have suggested the necessity of locating the least anticompetitive purchaser, not necessarily the only prospective or the only available purchaser.<sup>123</sup> Thus, other potential purchasers may exist, but the defense will not fail if the defendant can show that the actual purchaser has the least adverse impact on competition. There is no clear formula, however, for determining if the defendant has made such a showing. The test suggested by the Justice Department still appears to be the most satisfying standard: the failing firm must make a good faith effort to find a purchaser whose offer to purchase the firm is more consistent with the purpose of section 7 than the offer of any other firm.<sup>124</sup>

The one development in the failing company doctrine since *General Dynamics* has not affected the traditional elements of the doctrine. In *United States v. M.P.M., Inc.*,<sup>125</sup> the court stated that the failing company could be either the acquired or acquiring company because the underlying rationale of the doctrine would be fulfilled as long as one of the two merger partners was in a failing condition.<sup>126</sup> The court asserted that this was true whether one accepted the "choice of evils" rationale or the rationale that mergers involving failing com-

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119. Even when the parties have argued for modifications of the doctrine, the courts have refused to make any changes. In *United States v. M.P.M., Inc.*, 397 F. Supp. 78 (D. Colo. 1975), the Government argued that a company experiencing financial difficulty could not use the failing company defense if the industry as a whole was having difficulty. Closing Argument of Plaintiff at 8. The Government also contended that a close corporation could not claim to be failing when one of the shareholders had substantial personal assets that he could lend or give to the company. Plaintiff's Proposed Findings of Fact and Conclusions of Law at 23, 25. The court did not incorporate either one of these requirements into the elements of the failing company doctrine. Similarly, in *United States v. Black & Decker Mfg. Co.*, 430 F. Supp. 729 (D. Md. 1976), the defendant contended that the only available purchaser requirement did not apply to potential competition cases. *Id.* at 782 n.97.

120. See notes 46-48 *supra* and accompanying text.

121. *United States v. Black & Decker Mfg. Co.*, 430 F. Supp. 729, 778-79 (D. Md. 1976); *United States v. M.P.M., Inc.*, 397 F. Supp. 78, 99-100 (D. Colo. 1975).

122. *Citizen Publishing Co. v. United States*, 394 U.S. 131, 137 (1969); *Beegle v. Thomson*, 138 F.2d 875, 880 (7th Cir. 1943), *cert. denied*, 322 U.S. 743 (1944); *United States v. Maryland & Va. Milk Producers Ass'n.*, 167 F. Supp. 799, 808 (D.D.C. 1958), *modified*, 362 U.S. 458 (1960); see note 63 *supra*.

123. *United States v. Black & Decker Mfg. Co.*, 430 F. Supp. 729, 781-82 (D. Md. 1976); *United States v. M.P.M., Inc.*, 397 F. Supp. 78, 101-12 (D. Colo. 1975).

124. Merger Guidelines, *supra* note 2, at 6883-84.

125. 397 F. Supp. 78 (D. Colo. 1975).

126. *Id.* at 97-98; see notes 79-81 *supra* and accompanying text.

panies can have no anticompetitive effects, because the inquiry mandated by *General Dynamics* should consider economic realities rather than "technical labels."<sup>127</sup> The court's reasoning concerning this variation on the doctrine is sound. It is rare to find a failing company that has the financial ability to acquire another company, but such a phenomenon may occur through the exchange of stock or the creation of a holding company.<sup>128</sup> As long as the doctrine is applied to a merger involving a healthy company and a failing company, it should be valid no matter how incongruous the situation may appear at first.

### C. International Harvester: *Confusion of the Two Defenses*

When the court in *International Harvester* combined the failing company doctrine and the *General Dynamics* defense,<sup>129</sup> it built an analytical bridge between the two when no connection was intended. The court confused the purpose of the defenses by applying the underlying rationale of *General Dynamics* to a situation involving failing finances. If any defense were available in *International Harvester*, it would have been the failing company doctrine. The defendant's major concern was the lack of profitability of the acquired company, not its ability to compete in the future based on available resources. The defendant should not have been able to use the doctrine, however, because there was no evidence that the acquired company had made a good faith search for another possible purchaser.<sup>130</sup>

By extending a *General Dynamics* defense to include evidence that an acquired company is a weak competitor for financial reasons, the court has brought the continued viability of the failing company doctrine into jeopardy. Using the *International Harvester* rationale, a company that is failing is also a weak company and therefore would qualify to use either one of the defenses. Given a choice, no defendant would use the more stringent failing company defense if it could prevail merely by showing that it was a weak competitor and that the merger had provided badly needed funds.<sup>131</sup> It is crucial, however, that the elements of the failing company doctrine be met because, in providing a realistic exception to the antitrust laws that deals with the problem of companies in serious financial difficulty, the doctrine permits potentially anticompetitive mergers. In order for the doctrine to survive, courts must recognize the fundamental distinctions between the doctrine and the *General Dynamics* holding and must avoid the conceptual pitfalls created by *International Harvester*.

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127. 397 F. Supp. at 98.

128. Indeed, these were the facts in *M.P.M.*, in which the failing company had created a holding company which in turn had purchased both the failing and healthy companies. *Id.* at 83.

129. See notes 86-100 *supra* and accompanying text.

130. See 564 F.2d at 776; see notes 88-98 *supra* and accompanying text.

131. See *Horizontal Mergers*, *supra* note 19, at 511. Unfortunately, the reasoning in *International Harvester* is not a mere aberration. The proposition that a defendant relying on *General Dynamics* may raise as a defense the status of the acquired company as a weakened competitor has already been cited with approval on two occasions. *United States v. Consolidated Foods Corp.*, 455 F. Supp. 108, 136 (E.D. Pa. 1978); Note, *All the King's Horses and All the King's Men: The Failing Company Doctrine as a Conditional Defense to Section 7 of the Clayton Act*, 4 Hofstra L. Rev. 643, 678-79, 682-83 (1976).

## IV. MODIFYING THE FAILING COMPANY DOCTRINE

In distinguishing the failing company doctrine from the *General Dynamics* defense, the courts should also consider making certain modifications in the application of the doctrine in order to achieve its purpose. The doctrine has been applied consistently as an absolute defense in section 7 cases. Once the defendant satisfies the two traditional elements, courts have considered the defense to be established and have made no further inquiries into the anticompetitive effects of the merger.<sup>132</sup> The use of an absolute defense is undesirable, however, because it perpetuates the mistaken assumption that mergers involving failing companies do not have substantial anticompetitive effects.<sup>133</sup> An absolute defense also contradicts the inquiry mandated by the *General Dynamics* decision to consider the economic realities of the situation in section 7 cases and not simply to determine if narrow legal requirements have been fulfilled.<sup>134</sup> Under this standard, an absolute defense permits a superficial evaluation of a merger on the basis of only two elements and does not consider all the evidence necessary to demonstrate the full impact of the merger on competition within the industry. Indeed, the Court in *Citizen Publishing* may have established the more stringent requirements for the defense<sup>135</sup> in order to minimize its application and thereby compensate for the fact that the doctrine did not consider anticompetitive effects. The *Citizen Publishing* interpretation is inadequate, however, because it also fails to achieve a proper balancing of the effects of a merger. The Court established legal requirements for the doctrine that would be virtually impossible to satisfy. There is simply no sure method of proving with accuracy whether the reorganization of a company will be successful. It is also a nearly impossible task for a defendant to show that all potential purchasers were approached in order to prove that the actual purchaser was the only available one.

Several suggestions for modifying the failing company doctrine have been made. The most extreme suggestion is to eliminate the defense altogether and simply to consider the financial condition of the company as one factor, along with market share and concentration, in determining whether the merger is legal.<sup>136</sup> This alternative ignores the adverse effect of a business failure on the economy, which was the main reason why the Court in *International Shoe* established the doctrine,<sup>137</sup> and also contradicts the express congressional approval of the defense.<sup>138</sup> Another commentator has suggested that the application of the defense should depend on the imminency of a business failure. When the court can predict that failure is unavoidable without a merger, the defense should be applied absolutely. When it is uncertain that the company will fail, the

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132. *Beegle v. Thomson*, 138 F.2d 875 (7th Cir. 1943), *cert. denied*, 322 U.S. 743 (1944); *United States v. M.P.M., Inc.*, 397 F. Supp. 78 (D. Colo. 1975); *United States v. Maryland & Va. Milk Producers Ass'n.*, 167 F. Supp. 799 (D.D.C. 1958), *modified*, 362 U.S. 458 (1960). *But see* *United States Steel Corp.*, 74 F.T.C. 1270 (1968), *remanded*, 426 F.2d 592 (6th Cir. 1970), *discussed at* notes 143-47 *infra* and accompanying text.

133. *See* notes 111-12 *supra* and accompanying text.

134. *See* notes 58-68 *supra* and accompanying text.

135. *See* notes 41-45 *supra* and accompanying text.

136. Connor, *Section 7 of the Clayton Act: The "Failing Company" Myth*, 49 Geo. L.J. 84, 99 (1960); Levi, *The duPont Case and Section 7 of the Clayton Act*, 3 Antitrust Bull. 3, 11 (1958).

137. *See* notes 27-36 *supra* and accompanying text.

138. *See* note 40 *supra* and accompanying text.

defense should be applied only when there will be no anticompetitive effects.<sup>139</sup> The problem with this approach is that it looks primarily at the probability of business failure and makes the anticompetitive effects of the merger a secondary consideration.

The "lesser of two evils" purpose of the doctrine stated in *General Dynamics*<sup>140</sup> suggests the use of a relative rather than an absolute defense. In a relative defense, the establishment of the two elements of the doctrine would not automatically justify its application. After those elements were proven, the court would then balance the anticompetitive effect of the merger against the losses that would result if the merger were not allowed, such as lost investments, unemployment, and the impact of the company's failure on the industry.<sup>141</sup> Indeed, the Court in *International Shoe* used such an approach by considering factors other than the failure of the company and the presence of a prospective purchaser, including the good intentions of the company's owners, the losses that shareholders and employees would suffer, and the effect of the merger on market conditions in general.<sup>142</sup>

In 1968, the Federal Trade Commission also applied the doctrine as a relative defense in *United States Steel Corp.*<sup>143</sup> The case involved a vertical merger between the nation's largest steel company, which owned one of the four largest portland cement companies in the country, and a ready-mix concrete company operating in the New York metropolitan area. Portland cement is the most important ingredient in ready-mix concrete. Prior to the merger, the New York company was one of the largest ready-mix concrete companies and one of the largest consumers of portland cement in the relevant market, receiving one-half of its cement supply from United States Steel's cement company.<sup>144</sup> Although the Commission found that the elements of the defense had been met,<sup>145</sup> it refused to allow the merger, based on a two-part balancing test that it applied to the facts. First, the Commission determined that the acquisition would result in a substantial lessening of competition because competitors would be foreclosed from access to the portland cement market.<sup>146</sup> Second, the harm that would result to innocent individuals such as creditors, shareholders, and employees if the merger did not occur was not "so serious and substantial that the public interest re-

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139. Bok, *supra* note 112, at 343.

140. 415 U.S. at 507.

141. See Low, *supra* note 110, at 29.

142. 280 U.S. at 302. Subsequent courts applying the doctrine required the defendant to satisfy only the two legal requirements of the defense and did not consider the relative merits of allowing a merger as opposed to the effects of permitting a business to fail. See note 49 *supra* and accompanying text.

143. 74 F.T.C. 1270 (1968), *remanded*, 426 F.2d 592 (6th Cir. 1970).

144. *Id.* at 1275-76.

145. *Id.* at 1277-79. In its opinion, the Commission stated that the acquired company was in a failing condition based on evidence that prior to the merger it had a substantial deficit in net working capital, considerable operating losses, and an inability to meet payments on a \$3.3 million loan as those payments came due. *Id.* at 1278-80. Although the Commission did not discuss the element of only available purchaser in its opinion, it had determined, in its initial findings of fact concerning the merger, that the acquiring company was the only purchaser available at the time that the acquired company had approached it. National Portland Cement Co., 71 F.T.C. 395, 471-75 (1967).

146. 74 F.T.C. at 1291-1300.

quire[d] that the acquisition nevertheless be permitted."<sup>147</sup> The approach used in *International Shoe* and *United States Steel* is the proper application of the failing company doctrine in light of the *General Dynamics* requirement that courts look at a broad range of economic factors in all section 7 cases. No failing company analysis is complete without considering all evidence that may bear upon the impact of the merger on the industry.

Two objections that have been made concerning a relative defense are that the considerations required are too complex for the courts to handle efficiently, and that such a defense would result in a lack of predictability for defendants.<sup>148</sup> One answer to both objections is that the complexity and unpredictability of a relative defense is no greater than the complexity and unpredictability found in the *General Dynamics* defense, which requires both parties to present and respond to broad-ranging evidence. Also, some relief from both of these problems may be found by establishing guidelines for failing company mergers on an industry-by-industry basis.<sup>149</sup> Prototypes for these guidelines already exist in legislation governing failing company mergers in particular industries, including newspapers<sup>150</sup> and banking.<sup>151</sup>

The application of a relative failing company defense should conform to the following standards. After the Government presents its prima facie case of illegality, the defendant must then prove the two traditional elements of the doctrine as a threshold test for using the defense. If the court finds that the merger will have substantial anticompetitive effects, it should not be allowed unless the defendant shows that the losses to individuals and the resulting harm to competition in the market without a merger outweigh the anticompetitive effects of the merger. In making this decision, the court should consider two kinds of evidence. First, to determine what anticompetitive effects the merger will have, the court should consider (1) the magnitude of the merger, (2) the economic condition of the particular industry, and (3) the possibility of selling the failing company to two or more purchasers instead of one. Against this evidence, the court should balance the adverse effects of a business failure, including (1) the financial interests of

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147. *Id.* at 1288; *see id.* at 1304. The Commission previously had stated in dicta that the failing company defense was relative. *See Pillsbury Mills, Inc.*, 57 F.T.C. 1274 (1960), *vacated on other grounds*. 354 F.2d 952 (5th Cir. 1966).

148. Blum, *supra* note 49, at 99.

149. *Id.* at 98-99.

150. 15 U.S.C. §§ 1801-1804 (1976). The purpose of this Act is to preserve and maintain competitive urban newspapers, *id.* § 1801, and provides that a joint operating agreement between two or more newspapers is not a violation of the antitrust laws if, at the time that the agreement was made, not more than one of the participating newspapers was "likely to remain or become a financially sound publication." *Id.* § 1803(a).

151. 12 U.S.C. § 1828(c) (1976). This Act provides that all bank mergers, except those involving a failing bank, must first be approved by the agency responsible for its supervision, either the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation, on the basis of reports concerning "competitive factors" provided by the Attorney General. *Id.* § 1828(c)(4). A merger between two or more financially sound banks is not allowed if it would result in a monopoly or would substantially lessen competition unless the anticompetitive effects are clearly outweighed by the needs and convenience of the community to be served. When the merger involves a failing bank, this consideration of anticompetitive effects and public interest is dispensed with and the merger is allowed. *Id.* § 1828(c)(4)-(6).

people directly involved, including shareholders, creditors, and employees, (2) the interests of parties tangentially involved, such as consumers and members of the surrounding community, (3) the stability of the economy as a whole, and (4) social planning goals, such as helping small businesses, shielding particular industries from economic adversity, or promoting consumer interests.<sup>152</sup> No one element alone should be controlling, but rather all factors should contribute to the court's decision whether to allow the merger.

The list of factors suggested for use in applying a relative defense contains elements other than those concerned directly with competition or economic efficiency. Although the purpose of antitrust laws is primarily to engender and protect competition,<sup>153</sup> the failing company doctrine constitutes an exception to that principle. The purpose of the doctrine is to allow mergers that have anticompetitive effects in order to avoid the greater evils that result when a business fails, including not only adverse effects on competition, but also other losses to interested parties, such as employees, shareholders, and all community members.<sup>154</sup> When applying this defense, therefore, it is necessary to consider values other than pure competition in order to achieve the purpose of the doctrine.

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152. Some of these factors have already been suggested by commentators. Blum, *supra* note 49, at 103-04; Bok, *supra* note 112, at 343.

153. The latest statement of this principle may be found in *National Soc'y of Professional Eng'rs v. United States*, 435 U.S. 679 (1978), in which the Court stated that the purpose of any antitrust analysis is "to form a judgment about the competitive significance of the restraint," not to determine if the activity in question fosters public interest or the interests of a particular industry. *Id.* at 692. In that case, the Court rejected an argument that a ban on competitive price bidding among members of the society was valid because it promoted the public safety. *Id.* at 692-96; see P. Areeda & D. Turner, 1 *Antitrust Law* ¶ 104, at 8-9 (1978); R. Posner, *Antitrust Law: An Economic Perspective* at ix (1976); L. Sullivan, *supra* note 2, § 59, at 153. But see *Appalachian Coals, Inc. v. United States*, 288 U.S. 344 (1933) (restraint on competition upheld because of bad economic conditions within the industry). *Appalachian* is a notable exception to the general principle that the purpose of the antitrust laws is to maintain competition. Other exceptions have been enacted into law. See notes 150-51 *supra*.

154. See notes 113-14 *supra* and accompanying text.